Strategic Report

Idaho State Treasurer Diversified Bond Fund

For the Period Ending December 31, 2009

Total Return Commentary

The U.S. Treasury yield curve "steepened" during the fourth quarter of 2009, with rates moving higher at the longer end of the yield curve. The longer the maturity, the greater the increase in rates. Interest rates for 3-Month Treasuries actually moved down 6 basis points. Over the same period, rates on 2-Year Treasuries were up 19 basis points and rates on 10-Year Treasuries were up 53 basis points. Over the year, this movement of longer-term rates was even more significant, with 10-Year Treasuries up 162 basis points. At the beginning of the year, the difference in yield between 30-Year Treasuries and 2-Year Treasuries was 260 basis points. The difference at year-end was 459 basis points.

The increase in rates across the curve resulted in a negative movement in principal value for U.S. Treasuries, with the Intermediate U.S. Treasury Index down 0.6% for the quarter. This, however, was dwarfed by well-performing credit and asset-backed sectors. U.S. Intermediate Corporate bonds were up 1.6%, asset-backed securities were up 1.3% and the commercial mortgage-backed sector was up a respectable 3.3%. This follows two quarters when the Commercial Mortgage-Backed (CMBS) Index was up over 12%. For the year, the CMBS Index is up 28.5% after being "crushed" last year. The Barclay's Capital Intermediate Aggregate A+ Index (the portfolio's market benchmark) posted a positive return of 0.4% during the quarter with a year-to-date total return of 5.3%

During the quarter, the Diversified Bond Fund was up 0.5% with a year-to-date total return of 6.3% (excluding sweep cash). The outperformance for the quarter as compared to the index was due to a conservative maturity/duration stance and quality performance in the corporate and CMBS areas. Since inception in June of 2000, the DBF (including cash) has returned 66.0% which corresponds to a 5.5% annualized return. The current yield to maturity for the Diversified Bond Fund is 3.0%. The effective weighted average duration for the portfolio is just 2.9 years. The duration of the comparable index is 3.7 years.

Portfolio-Specific Issues

Total return in a fixed-income portfolio is made up of income and principal fluctuations due to changes in interest rates. In a rising interest rate environment, the principal value of fixed-income securities can decrease. If participants invest principal for a time period shorter than the portfolio duration they could face a situation where they could lose money on a total return basis. Accordingly, participants are encouraged to place only assets that are expected to be invested over a 3.5 year or longer period in The Idaho State

Treasurer's Diversified Bond Fund. In addition, participants are encouraged to reinvest as much of the income as possible to fully participate in the benefits of the Diversified Bond Fund and its focus on total return.

Market and Portfolio Commentary

The fixed income markets continued to be quite volatile during the fourth quarter. For example, rates on 5-Year U.S. Treasuries began the quarter at 2.31%. By the end of November, rates were at 2.00% and by the end of the year, rates were at 2.68%. There were rallies in some sectors as the pace of severe negative economic news continued to slow. Although the Diversified Bond Fund is not a speculatively traded fund, the volatility in interest rates and rotating sector bias/performance creates an environment where increased turnover in the portfolio might be more advantageous.

We have significant concerns regarding the economic and fixed income environment in the intermediate-term to longer-term. Large federal and trade deficits, a potentially weakening dollar, as well as under-supply/increasing demand issues for commodities including energy and raw materials could result in higher inflation and rapidly rising interest rates at some point in the U.S. However, continued economic struggles and slower growth in the short-run will likely keep rates from rising too quickly.

We will be increasing duration, but will continue to maintain a duration less than the benchmark. We will overweight the mortgage sector, and look to overweight the U.S. government agency sector as we feel these continue to provide the best current relative value.